Optimal Income Taxation with Unemployment and Wage Responses: A Sufficient Statistics Approach

Kory Kroft¹, Kavan Kucko², Etienne Lehmann*³, and Johannes Schmieder²

¹Department of Economics, University of Toronto – Canada
²Department of economics - Boston University – United States
³Centre de Recherches Economie et Droit - Université Pantheon-Assas Paris II (CRED) – CRED – 12 place du Panthéon, 75231 Paris Cedex 05, France

Abstract

We derive a sufficient statistics optimal tax formula in a general model that incorporates unemployment and endogenous wages, to study the shape of the tax and transfer system at the bottom of the distribution. The sufficient statistics are the macro employment response to taxation and the micro and macro participation responses. We estimate these statistics using policy variation from the U.S. tax and transfer system. Our results suggest that the optimal tax more closely resembles a Negative Income Tax than an Earned Income Tax Credit relative to the case where unemployment and wage responses are not taken into account.

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*Speaker